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Abstract

Tax rates on business income in many countries increased enormously during World War I and stayed at a much higher level than before the war. Particularly, the UK multinationals with subsidiaries based elsewhere other than the Empire suffered from the situation because the UK did not provide a foreign tax relief until 1945, when a tax treaty with US was signed.

The aim of this paper is to clarify the historical premises of establishment of the tax treaty in 1945. The major premise of this paper is that the double income tax discouraged Britons' investment and impaired their competitiveness in US in 1914-1945. Nevertheless, it took three decades to realise the treaty. The first step was a 1936 tax on dividends paid to corporate shareholders. UK multinationals had to pay American dividend tax as well as British income tax and American corporation tax. For instance, J&P Coats, which had extensive interests in the US, would have had to pay a dividend tax of 10 percent. J&P Coats succeeded in tax planning which reorganised their British and American subsidiaries. Nonetheless, J&P Coats and other companies petitioned the UK government to eliminate the double income tax. The second step towards realisation of the treaty occurred after the outbreak of World War II. The problem of double income tax made a number of corporations regard transfer pricing as a method to avoid US taxation. Transfer pricing by using two invoices was, however, unsatisfactory to at least UK government authorities. UK abandoned inter-imperial preferential tax credit substantially through the negotiation with US in 1944-1945.

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1. Introduction

This paper clarifies the extent to which multinationals responded to international double taxation on business income (double income tax), which had been recognised as a serious problem since the Firs World War. The paper also explores how reactions by multinationals formed international tax policy. To make clear these points would provide food for thought to deal with the today's topic about tax avoidance of multinationals such as Pfizer and the plans of global tax advocated by reformists like the members of a panel in the United Nations (OECD 2013, p. 13; Economist 2014; United Nations 2001, p.28).

In particular, this paper takes up the behaviours of UK multinationals in the US from 1914 to 1945 and the UK-US tax treaties in 1945. The reason is that the UK had the largest stock of outward FDI in the world between 1914 and 1938 (Jones 2005, pp. 21-22). Besides that, according to Picciotto (1992), a turning point in the development of international tax arrangements through bilateral tax treaties after the Second World War was the successful UK-US tax treaty in 1945.

Among previous studies, Wilkins (2009) highlights that double income tax curtailed UK foreign investment in the US, but she cites scant examples involving UK multinationals. The extent to which double income taxation influenced UK multinationals and the reasoning underlying the UK-US tax treaty remains unspecified. Picciotto and Jones (2009) describes briefly the history of UK-US discussions over double income tax, drawing mainly on official records from the Foreign Office and the UK's Inland Revenue. Although they convincingly describes the process of the treaty from a political perspective, they do not pay attention to the action of companies affected by double income tax. They then assume that the multinationals continued to complain about the double income tax strongly from 1914 to 1945. Eventually, they do not elucidate how and why the bilateral treaty with the US originated and was supported (or not supported) in the UK.

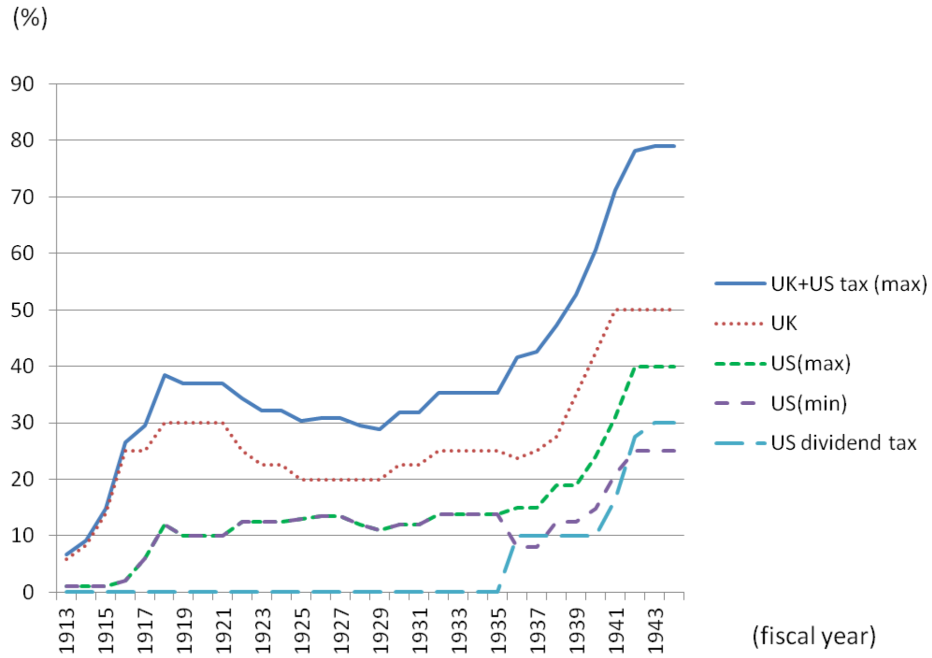
We explore how UK multinationals adapted to double income tax and why the bilateral tax treaty was concluded in 1945. We follow corporate behaviour based on a case study constructed on the basis of company material (J & P Coats), as well as records of general meeting of stockholders in newspaper archives, a record of the Federation of British Industries and some official government documents.

2. The road map to the UK-US treaty

The problem of double income tax in the UK deteriorated mainly because income tax rates all over the world as well as in UK increased after the outbreak of the First World War. For example, in 1913, a UK multinational which was resident in UK but had a branch in US was obligated to pay US tax (1%) on its US profit of £100 and UK tax (5.8%) on its net profit of £99, leaving a net profit of about £93.3 (See Figure 1).[2] However, by 1918, such a UK multinational was forced to pay a US tax of 12.5% on its £100 profit and UK income tax of 30% on its net £87.5 foreign income. Thus, net profit on same amount of gross profit dropped from £93.3 to £61.6. In spite of the fact that the double income tax between UK and US was recognised as a hardship, foreign tax relief or tax treaty between UK and US was forgone in inter war period. This section investigates the behaviours of UK multinationals and the process of making bilateral tax treaty with US between 1914 and 1945, dividing the time period into five parts.

[2] This paper only uses US federal tax to avoid confusion. See the footnote No.3 in this paper, which provides information about other taxes.

Figure 1 The rate of income tax on business income of the UK and US, 1913-1944



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2. 1 1914-1919 —Occurrence of the problem of double income tax

In this period, the issue of double income tax became a public concern, which provoked complaints against the problem by UK multinationals and suggestion of plans to resolve it.

The first complainant about the double income tax problem between UK and US was the Investment Trust Corporation, a trust company which invested in US securities. The company complained about tax increases in the US, claiming that 'the future may, in this direction, hold grave dangers for a country like our own' (*The Times*: Investment Trust corporation, 1916). J&P Coats, a thread company which had extensive interests in the US, also complained about double income tax internally in its general meetings in 1918 and 1919 (J&P Coats: GB 0248 UGD 199/1/1/67).

In response to such complaints, the Royal Commission on Income Tax, which was established in 1919, took up the double income tax problem to try to find a solution to it. In the Commission, two witnesses explained the difficulties caused by both UK and US taxes. One witness, Archibald Willamson, who was a Member of Parliament of the UK as well as an owner of a trading company based in UK and US, explained the plight of his company, suggesting a worldwide foreign tax credit scheme such as that in the US. He also mentioned that separation of foreign houses from their head office in the United Kingdom was becoming more common and the independence of the foreign houses must eventually tend to weaken the tie with Britain. He worried about the loss of British commerce caused by double income tax (Minutes of Evidence, [7405-7659]). Another witness was more important. Adam Morimer Singer, who was a son of the founder of the Singer Manufacturing Company, protested against the severe taxes and suggested the UK-US bilateral tax treaty to prevent double income tax (Minutes of Evidence in Royal Commission, [5179]). That is to say, the idea of bilateral treaty between UK and US was born almost at the same time as the double income tax problem, albeit the embodiment of the bilateral tax treaty in 1945.

2. 2 1920-1924 — Rebuff of double income tax relief outside Empire

Despite the discussion in the Royal Commission, the UK did not provide the double income tax relief other than for the British Empire. Nevertheless, it did not reject the idea of bilateral tax treaty completely. On the other hand, UK multinationals responded to the evolving business conditions, changing their business organisation and investment strategy to deal with the double income tax in other ways.

The final report of the Royal Commission on Income tax recommended no change in the existing situation as to double income tax by the United Kingdom government and by the government of foreign states. On the contrary, it encouraged the introduction of foreign income tax relief within the British Empire up to one-half of the rate of the UK income tax. The reason of the difference between in and outside the Empire was that the government authorities such as Inland Revenue abhorred losing financial sources. The difference was also affected by the fact that the Association of Protest against the Duplication of Income Tax within the Empire, established in 1915, demanded the tax relief within the British Empire strongly. On the contrary, similar groups to demand the tax relief outside the Empire eagerly did not appear. Then, the UK established the Financial Act 1920 which only provided the income tax relief within the British Empire (The Association of Protest against the Duplication of Income Tax within the Empire 1916, Seed and Rawlinson 1925, p.5, The Report of the Royal Commission on the Income Tax 1920, pp. 16-19).

However, the report did not wipe out the idea of bilateral tax treaty. It also recommended putting forward the idea under the auspices of the League of Nations. Thus, the concept of bilateral treaty was officially accepted but was restricted to the term, 'under the auspices of the League of Nations', in the report of Commission (Report of Commission 1920, p.19).

In response to the enactment of the unequal tax relief, UK multinationals based in the US chose to change their investment strategy and business organisation. For example, Investment Trust Corporation, mentioned above, practically gave up its investments in the US. Its holdings in US securities fell from 37% of its all investment in 1914 to 3% in 1923 owing to the double income tax. The company also stated that it did not plan to re-entry into US in the near future (*The Times*: Investment Trust Corporation, 1923). The case of Arizona Copper Company, a UK mining company which had a US division, was more drastic. On September 1921, it decided to sell the US division to Phelps Dodge, a US mining company. According to the *Times* report, one of the main reasons was the double income tax (*The Times*: Arizona Copper Company, 1921).

2.3 1925-1935—Impasse of debate about double income tax

Although the discussion about double taxation (including double taxation on business income) in the League of Nations was sparked off just after the foundation, concrete measures to solve the problem could not be realized either internationally or in the UK. On the other hand, taxes on business income levelled off in this period. Although the governments did not have the reason to levy the taxes more, they had no reason to reduce the taxes which became the foundation of the social welfare. In addition to the fact that UK multinationals reorganised their business just after the War, the complaint of UK multinationals was placated.

The committee of Technical Experts, a special committee in the League of Nations, acknowledged in 1925 that multilateral tax treaty method had a difficulty of viability because different countries had different tax rules. And it suggested that countries conclude bilateral agreements. Following the suggestion, the League of Nations made model bilateral tax treaties in 1928 which were expected to be basis for some bilateral tax treaties. However, the model tax treaties had a drawback. They requested the concession of tax revenue of capital-export countries such as the UK because they acknowledged that host countries could impose taxes on business income partially (Picicotto, pp.18-24).

In response to the discussion in the League of Nations, the Federation of British Industries, which was one of the largest employers' association in the UK, requested bilateral tax treaties without the auspices of the League of Nations in negotiations with the Inland Revenue in 1925 and 1929 (Federation of British Industries: MSS200/F/3/E4/5/1). Although Winston Churchill, the Chancellor of the Exchequer in 1926, agreed with the group's idea, Philip Snowden, the Chancellor in 1930, only stated that international conference might 'come to some satisfactory conclusions' (*The Times*: 'Tax Burdens on Industry' 1926; *The Times*: 'British Trade Paradoxes' 1930). Yet again, the reason why UK government authorities abhorred concluding tax treaties based on the model treaty was that they did not want to give up their tax source.

In contrast with the political standstill, business conditions improved, mainly because tax rate of both countries levelled off. As for corporate behaviour, Swan Land and Cattle Company in 1926 converted its US division into US subsidiaries in order to escape the UK income tax (Wilkins 2004, p.222).[3] On the other hand, newspapers such as *the Times*, *the Financial Times* and *the Economist* at that time did not report any complaints about double income tax between UK and US, with one exception. The Olympic Portland Cement Company, a cement maker mainly based in US and UK complained about the double income tax problem every year (at least from 1924 to 1944) at its general meeting. The company, however, only complained about the double income tax between UK and US. It is unknown whether the company engaged in tax planning or not (*The Times*: Olympic Portland Cement Company).

2.4 1936-1939—Triple tax

The impasse of the political debate about double income tax continued during the period from 1936 to 1939. Yet the introduction of US dividend tax in 1936 exacerbated the business situation more. UK multinationals were forced to adapt to the environment, again.

The US Revenue Act 1936 taxed dividends paid to corporate shareholders (United States Government Printing Office 1936). As a result, UK multinationals had to pay American dividend tax as well as American corporation tax and British income tax. For example, a UK multinational based in the US suffered from the US dividend tax of 10%, US corporation tax of 15% and UK income tax of 23.75% in 1936. When a US subsidiary of UK multinationals paid the dividend to its parent company, the corporate group was obligated to pay US corporation tax (15%) on its US profit of ￡100, US dividend tax (10%) on its net profit in the US of ￡85 and UK income tax (23.75%) on its net profit of ￡76.5, leaving a net profit of about ￡58.3.[4]

[3] Converting branch into subsidiary could prevent double income tax unless the US subsidiary remitted its profit to the parent company, due to the fact that UK tax authority could not levy its income tax on overseas legal entity.

Needless to say, the double income tax problem with US became a public concern for the first time in about 20 years. *The Times* and *the Economist* reported the double income tax problem between UK and US in 1937 (*The Times*: ‘Double Taxation and the U.S.A.’ 1937; *The Economist*: ‘Invest Notes’ 1937). In the annual meeting of the H. P. Sauce, a sauce product company which had large interests in the US, stockholders complained about the double income tax problem in the general meeting in 1938 and 1939 (*The Times*: H. P. Sauce 1938, 1939).

Furthermore, with regard to the case of J&P Coats, we can follow the detailed steps taken in response to the double income tax problem. The company reorganised their business group structure to avoid the triple taxes.

On 26 September 1936, the Liaison Committee 4, which was a division of J&P Coats and administered to harmonize communication between US and UK, received a proposition of tax planning from the Executive committee in New York. The proposition was that they wanted to avoid the additional taxation because, ‘as a result of recent legislation, a tax of 10% would, in future, be levied on dividends paid to the Parent Company’ (GB 0248 UGD 199/1/1/82, p. 233). This motion of tax planning was dealt in the Financial Committee which was also a division of the headquarters and administered the company’s finances.

After consulting with Barrow, Wade, Guthrie & Co, a US accounting firm that

[4] According to a report made by the British Empire Chamber of Commerce in the United States of America in 1938, the effect of double taxation on the profits of a typical subsidiary company located in New York States with a declared capital stock value of $5,000,000 and earnings of $500,000 before taxes was shown below:

	Tax Rate	Profits subject to Tax	Amount of Tax
State Income or Financial Tax	6%	$500,000.00	$30,000.00
Federal Capital Stock Tax: ($1.00 per $1,000 of declared value)			$5,000.00
Federal Income Tax	16.5%	$465,000.00	$76,725.00
Federal Tax on Dividends	10%	$388.275.00	$38,827.50
National Defence Contribution Tax (UK)	5%	$349,447.50	$17,472.37
British Income Tax	27.5%	$331,975.13	$91,293.16
Total Tax			$259,318.03 (51.87% of Profits)

had originated as a British accountancy firm, J&P Coats decided to engage in tax planning starting on 16 November 1936. The decision also meant that J&P Coats reorganised its group structure because the US dividend tax could be circumvented if income of its subsidiaries in the US was less than half of world income of J & P Coats (GB 0248 UGD 199/1/1/24, p. 328; Wilkins 1989, p.536).

Specifically, J&P Coats let an existing UK subsidiary, I. P. Clarke & Co., took over total holdings in the US subsidiary companies. I. P. Clarke & Co. took over from J&P Coats its entire holdings in the J&P Coats (Rhode Island) and United Thread Mills, both of which were US subsidiaries of J&P Coats. In addition, I. P. Clarke & Co was converted into a Private company due to the reason that the UK company law at that time permitted the private company not to register their profit and loss balance sheet. Namely, I. P. Clarke & Co. could conceal information about the company profits from the public (GB 0248 UGD 199/1/1/24, pp. 328-329, 331, Gower 1969, p. 13).

According to the material of Financial Committee, the estimate of tax saving in a year was ＄126,000（￡25,200）whereas the cost of the scheme was ＄20,000, clearly a good investment in 'tax planning'. And the saving money was equivalent to about 1.3% of total profit of J&P Coats in 1936, ￡1,925,137. Then, the tax planning was approved by the board meeting on 1 Dec 1936 (J&P Coats: GB 0248 UGD 199/1/1/82, p.240; GB 0248 UGD 199/1/1/24, pp. 329; UGD 199/1/1/5).

Although some companies managed to the impact in 1936, the triple tax worsened as time went on. Even J&P Coats which executed the tax planning successfully in 1936 must have reviewed the scheme on 14 February 1938 because 'the chance of avoiding taxation had been worsened since November 1936'. However, the board decided not to put forward to the further tax planning at that juncture (J&P Coats: GB 0248 UGD 199/1/1/24, pp. 387, 389).

2.5 1940-1944—Outbreak of Second World War

The double income tax problem deteriorated sharply mainly because of the outbreak of the Second World War. This tax burden encouraged the UK multinationals to engage in more skilful tax planning and led to the negotiation of the UK-US tax treaty in 1945.

In this period, both governments levied tax on business income heavily. For example, in 1944, UK income tax surged to 50%. The US also levied corporation taxes of 25% to 40% as well as a dividend tax of 30%.

In response to the tax situation, UK multinationals based in the US engaged in tax planning more keenly. And a variety of UK multinationals complained about the double income tax problem in their general meetings. Eventually, the UK Treasury was forced to prohibit companies domiciled in the UK from transferring their businesses abroad without the prior consent of the authority on 27 September 1940 (*The Times*: 'Transfer of companies abroad' 1940). Moreover, it was unveiled in the meeting between Treasury, Foreign Office and Inland Revenue that British firms with major US subsidiaries (thought to number 57) had taken legal advice about ways to circumvent the double income tax. In particular, transfer pricing using double invoices was taken up an imperative matter to be solved. According to a material of the meeting, "One method is to fix a maximum invoice price here at such a level that the American branch makes no profit. This meant showing two prices on the invoice, but even so the American customs accept the lower price and take no notice of the higher price to the ultimate purchaser" (Foreign Office: FO371/38588).

As a result, many multinationals' complaints and tax planning encouraged the UK Foreign Office to discuss and negotiate a bilateral tax treaty with US. It also abided by the spirit of the Atlantic Charter. Thus, the UK-US tax treaty in 1945 was established in response to economic and political demand.

3. Conclusion

Double income tax problem appeared during World War impeded investment in the US by UK multinationals, which complained about the problem. One witness in the Royal Commission on the Income Tax in 1919 suggested a UK-US bilateral tax treaty and addressed the issue in its 1920 report, but it recommended only instituting tax relief within the Empire and concluding bilateral tax treaties under the auspices of League of Nations. The Finance Act of 1920 provided no relief outside the Empire, but it prompted multinationals based in the UK and US to reorganise business structures and investment strategies shortly after World War I ended.

Although discussions about double income tax in the League of Nations produced model bilateral tax treaties in 1928, the solution could not be realized in the UK because British authorities were reluctant to relinquish tax revenue. Moreover, change of UK international tax policy was not needed in the first half of the interwar period, mainly because the tax rate had been levelled off and UK multinationals had completed their business reorganisations.

The year 1936, when the US added a dividend tax, was pivotal in the development of UK-US double income tax. Along with the deterioration of tax burden, UK multinationals engaged in more skilful tax planning. After considering current and future business and political conditions, the UK government decided to conclude the bilateral tax treaty with the US in 1945.

In sum, double income tax from 1914 to 1945 compelled UK multinationals in the US towards tax planning to alleviate its impact. For companies such as Arizona Copper, that meant liquidating US operations. Some UK multinationals avoided double tax by reorganising their business structures as J & P Coats did. Or others engaged in transfer pricing. Although the current media report how multinationals, such as Pfizer, use different national tax systems to avoid taxes and are likely to regard it as a novel matter, the topic is a century old.

The response of UK multinationals affected the conclusion of UK-US tax treaty in 1945.

However, the UK multinationals not always claimed the settlement of the double income tax problem strongly throughout the period. The response sometimes did not support the political movement to solve the double income tax problem. The UK multinationals did not stress on settlement of the double tax problem between 1925 and 1936 since those based in the US had completed reorganising their structures and investment strategies just before. The response would contribute to the rebuff of debate in the League of Nations as well as application of bilateral tax treaties with the US without the auspices of the League of Nations. Yet it does not mean that the response to multinationals determined the conclusion of bilateral tax treaties. When the UK multinationals in the US complained a lot about the double income tax between 1914 and 1925, the idea of tax treaty with the US, came up with in 1919, was shelved politically. Eventually, the UK–US tax treaty was concluded in 1945 because political and business demands are matched at last during the World War II. The history of making tax treaties in 1945 indicates that creation of international tax policy is based on harmony of economic and political aspect as well as reality and ideal.

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